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ROLE OF TRANSNATIONAL CORPORATIONS IN SERVICES, INCLUDING TRANSNATIONAL BANKS: ROLE OF TRANSNATIONAL BANKS

Transnational banks and the external indebtedness of developing countries

Report of the Secretary-General

SUMMARY

The debt of developing countries to transnational banks has shown a downward trend in recent years. This, however, does not offer any basis for complacency, for several reasons: the prices of the debt instruments on the secondary markets have continued to decline; their debt-servicing capacity has not improved; and negative transfers from transnational banks to highly indebted countries have increased.

The significant reduction in the stock of the debt of developing countries to transnational banks has been facilitated by a variety of regulatory adjustments, including capital adequacy guidelines, the accounting and tax treatment of loan-loss reserves and the accounting and tax treatment of debt-restructuring instruments. This report reviews the modifications introduced in several creditor countries and examines their implications for the incentives of transnational banks to participate in debt-reduction efforts and/or grant new loans as a means to provide cash-flow relief. Some areas for improvements in regulatory frameworks are pointed out in the context of discussion of adjustments in each creditor country. The report also suggests some general areas for further reforms. Those concern

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modifications in risk-weighted capital guidelines, tax deductibility of discounted asset sales, differentiated accounting treatment of loans to developing countries and accounting rules for banks which do not agree to participate in debt reduction efforts. The report points to the need for closer coordination among creditor countries in formulating regulatory policies to facilitate debt-reduction and a greater commitment on the part of political authorities in creditor countries to ensure that transnational banks respond positively to the incentives offered through regulatory adjustments.

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INTRODUCTION

1. At its sixteenth session, the Commission on Transnational Corporations adopted a resolution requesting an updated report on the role of transnational banks related to the external indebtedness of developing countries, giving particular attention to the obstacles and problems that transnational banks face in debt reduction. 1/ The present report is in response to that request.

2. In a report submitted to the Commission at its sixteenth session, it was observed that the announcement of the Brady Plan in March 1989 marked a watershed in the perception of the role of transnational banks in the international debt problem. 2/ It represented a shift of emphasis from the maintenance of the stream of debt-servicing payments to debt reduction. It also recognized explicitly the need for actions by creditor country Governments to reduce accounting, regulatory and tax impediments to debt reduction. Taking into account this background and the resolution noted above, the present report provides an update on the indebtedness of developing countries to transnational banks, reviews the recent changes implemented by creditor countries in accounting, regulatory and tax practices which impinge on the role of transnational banks in debt reduction, and suggests several areas for further action.

I. TRANSNATIONAL BANKS AND THE EXTERNAL INDEBTEDNESS OF DEVELOPING COUNTRIES: AN UPDATE

3. The debt of developing countries to transnational banks has shown a clear downward trend in recent years. Between 1987 and the first quarter of 1990, commercial bank claims on all developing countries declined from $650 billion to $617 billion. Of particular interest in the context of this report is the situation of developing countries with severe debt problems. As can be seen from the data presented in table 1, the claims of commercial banks on this group of countries have declined significantly and consistently over the period 1987 to 1990.

4. In spite of this reduction, there are several considerations which provide a compelling logic against any complacency towards the debt problem:

(a) The debt overhang problem has not abated for most countries. One clear piece of evidence is the continuing decline in the secondary market prices of developing country debt. The weighted average price declined from 71 cents per dollar at the end of 1985 to about 34 cents per dollar in November 1990. 3/ The magnitude of decline has, of course, been sharper for some countries (e.g., Argentina and Brazil) than for others (e.g., Mexico and Venezuela). One notable exception is Chile, the market price of whose debt has increased to 73 per cent of face value;

(b) Only five debtor countries (Costa Rica, Mexico, Morocco, the Philippines and Venezuela) have succeeded in concluding debt-restructuring agreements with transnational banks in the framework of the Brady Plan. A combination of moral suasion, active marketing by the bank advisory committees and regulatory

adjustments by creditor countries was required in order to achieve the full participation of transnational banks in protracted negotiation processes. Considerable uncertainty remains regarding similar agreements for other countries, particularly those where the absolute volume of bank debt is modest and where transnational banks have little long-term business interests;

Table 1. Commercial bank claims on highly indebted developing countries

(Millions of dollars)

Country	1987	1988	1989	1990 a/
Argentina	35 252	37 627	32 367	31 096
Bolivia	726	566	353	327
Brazil	81 004	75 975	70 851	68 025
Chile	12 870	10 936	9 061	8 682
Congo	1 510	1 238	1 085	1 020
Costa Rica	1 382	1 264	1 084	1 002
Cote d'Ivoire	3 666	3 364	3 302	6 413
Egypt	7 562	6 741	6 589	6 413
Ecuador	5 066	4 890	4 582	4 295
Honduras	517	487	412	376
Mexico	75 845	71 499	70 158	55 567
Morocco	5 649	5 077	5 174	5 175
Nigeria	10 687	8 906	7 443	7 502
Peru	5 052	4 520	4 068	3 973
Philippines	14 354	12 329	9 640	9 012
Senegal	897	802	502	439
Uruguay	2 115	3 299	2 037	2 091
Venezuela	25 023	25 565	24 132	22 757
Total	289 177	275 085	252 840	234 165

Source: Bank for International Settlements, International Banking and Financial Market Developments, various issues.

a/ First quarter.

(c) The reluctance of banks to provide new money or even maintain exposure has led to shrinking net flows and negative net transfers. Negative net transfers because of long-term commercial debt to 17 highly indebted countries is estimated to have increased from $17 billion in 1985 to $21 billion in 1989; 4/

(d) The macroeconomic and financial situation of debtor countries remains very sensitive to external shocks. Fragility is reflected in the comparison of the interest rate on the outstanding debt with the rate of increase of exports of goods and services. The logic of that criterion is that the rate of interest represents the amount of additional debt that has to be taken on to pay annual interest service. If export growth, in percentage terms, equals at least the interest rate, a country can increase its debt while stabilizing its interest to export ratio. The real interest burden, measured by the nominal interest costs deflated by the rate of change in the index of export prices of developing countries, increased substantially owing to a combination of high interest rates and a decline in export prices over the period 1981-1985. Though average external interest rate declined to about 9 per cent in 1988-1990 from more than 13 per cent during 1982, export growth has been unable to improve interest-to-export ratios. 5/

Notwithstanding these qualifications, there has been a significant debt reduction, as noted above. To some extent, this has been facilitated by regulatory changes in creditor countries. The following chapter reviews those changes and their implications for the participation of transnational banks in future debt reduction/cash-flow.

II. ACCOUNTING, REGULATORY AND TAX ADJUSTMENTS IN CREDITOR COUNTRIES

5. From the point of view of participating in debt-reduction efforts or reducing the cash-flow problem arising out of debt-servicing needs, regulatory regimes are important because they determine the impact of financial transactions on a commercial bank's profit-and-loss account as well on its capital position. Other things being equal, a bank will strive to maximize its profit while minimizing capital and reserve needs, so as to limit the funding costs of assets. The discussion in this chapter focuses on three major elements of regulatory regimes: capital adequacy requirements, the treatment of loan-loss provisions and the treatment of debt-restructuring instruments.

A. Risk-weighted capital adequacy guidelines

6. In July 1988, the members of the Committee on Banking Regulations and Supervisory Practices of the Bank for International Settlements agreed on a framework for assessing capital adequacy and for setting minimum capital/asset ratios by the end of 1992. In addition, the so-called "Cooke Committee" adopted a definition of a dual structure for bank capital - namely, core, or tier 1, capital, consisting of equity capital and disclosed reserves, and supplementary, or tier 2, capital comprising undisclosed reserves, asset revaluation reserves, subordinated term debt and general loss reserves. The Committee also limited inclusion of

general loan-loss reserves in capital in amounts up to 1.25 per cent of risk assets, while specific reserves were excluded. Finally, the Committee established risk-weighting factors in order to define capital targets. The main impact of risk-based capital rules is to make bankers more selective in the use of risk-based capital and impose drastic asset portfolio rebalancing decisions. As a result of the new capital targets, banks can either mobilize capital, reduce assets, or restructure the balance sheet, depending on various risk factors.

7. Banks have to reach a minimum 7.25 per cent target ratio of capital to risk-weighted assets by the end of 1990 and a ratio of 8 per cent by the end of 1992, of which the core capital element should be at least 4 per cent. In order to evaluate the bank capital adequacy, five different categories of assets are assigned weights according to their perceived riskiness. Each asset type is assigned a weight of 0 per cent, 10 per cent, 20 per cent and 50 per cent or 100 per cent to reflect its risk characteristics. By this method, higher risk assets will demand higher levels of capital support. For example, claims on developing countries' central Governments that are denominated in local currency receive a 0 per cent risk weight. Short-term loans to developing countries and claims guaranteed or collateralized by the international financial institutions receive a 20 per cent risk weight. All other claims receive a 100 per cent risk weight.

8. The risk-weighted capital rules are likely to have greater effect on the participation of transnational banks from France, Japan and the United States, as explained below. These rules should not pose any major problems for the banks from other creditor countries, as they are well capitalized.

1. France

9. In France, commercial banks have taken measures to meet the capital requirements. In particular, French banks have increased general loan-loss reserves in order to increase tier-2 capital elements. However, the inclusion of reserves in regulatory capital is only a temporary substitute for equity for French banks owing to the upcoming limitation of reserve inclusion in capital to 1.25 per cent of risk assets at the end of 1992, as noted above. Regarding new money transactions, French banks face the additional constraint of reserving incremental exposure at the same level as existing developing country assets. As a result, commercial banks are very reluctant to participate in new money packages and have delayed the finalization of loan agreements on several occasions. Regarding debt-reduction transactions, any discount leads to an accounting loss to be charged against reserves. The inclusion of reserves in capital, in turn, leads to a capital loss. Other things being equal, French banks, therefore, tend to oppose debt-reduction transactions and prefer debt-servicing reductions through reduced interest par bonds.

2. Japan

10. The implementation of risk-adjusted capital rules based on the guidelines will have a significant impact on the Japanese banks, which will need to alter substantially the size and composition of their capital base and restructure their balance sheets. The Ministry of Finance chose a liberal interpretation of the rules in April 1988 to the benefit of the Japanese banks. In particular, holdings of capital instruments of other banks will not be deducted from the computation of the holder's regulatory capital. Until the recent stock market plunge in Tokyo, banks were able to rely on substantial "hidden reserves" owing to the difference between book and market values. Japanese banks may count as capital 45 per cent of the value of the unrealized gains on security holdings. Traditionally, Japanese banks possess a large volume of tier-2 capital, resulting from unrealized gains in their equity portfolio. The sharp drop in Japanese equities and bonds during 1990, coupled with the relative decline in the yen value, makes it more difficult to meet the capital rules. In addition, the rise in interest rates has trimmed operating profits severely, thereby making it more difficult to boost capital.

11. Growing concerns regarding the profitability and domestic assets base of banks led the United States credit agency Moody's to put several Japanese banking institutions on its credit review list in September 1990, following the downgrading of the Dai-Ichi Kangyo and Fuji Bank. In November 1990, Moody's downgraded the Sumitomo Bank, the world's second-largest bank, as well as the other large Japanese banks - namely, Mitsubishi, Tokai and the Long-Term Credit Bank. The new emphasis on assets with favourable risk weighting, such as mortgage loans and government bonds, will lead Japanese banks to be more reluctant to participate in new money operations.

12. Despite steady increases in loan-loss reserves, the Japanese banks' coverage ratio remains below the level achieved in other creditor countries and below the interim capital adequacy requirement of 7.25 per cent. The relatively weak capital position of Japanese banks is likely to lead to larger developing countries' asset sales on the secondary markets. Thus, Japanese banks will be more reluctant to participate in new money operations.

3. United States of America

13. In the United States, transnational banks face the triple constraint of an ongoing erosion in the value of developing country claims, as reflected in declining prices in the secondary markets; deteriorating asset quality in real estate portfolios and loans for highly leveraged transactions; and interim capital adequacy targets at the end of 1990. United States banks have resorted to a range of modalities to strengthen their capital ratios, including increasing reserves, raising equity and decreasing assets. Owing to the inclusion of general loan-loss reserves in regulatory capital in the United States, banks have added about $8 billion to long-term developing country loan reserves during the first half of 1990. In addition, a combination of net charge-offs, allocated transfer risk reserves and loan sales have led to a sharp reduction in the ratio of developing country loans to total assets and to capital. United States banks are in the

process of restructuring the composition of their portfolios in order to take full advantage of the risk-weighted guidelines. As a result, their total outstanding developing country claims dropped to $79 billion at the end of 1989, compared with $93 billion a year earlier.

14. The equity positions of the United States money-centre banks have also improved significantly during 1989, with close to $2 billion in new equity issues by Chase, Chemical and Manufacturers Hanover. As a result, the ability of the United States banks to withstand further loss potential from developing country loans has increased. Most of the United States regional banks are now fully reserved against developing country loans. In addition, banks with small exposures sold large quantities of developing country assets on the secondary markets during 1986-1989. Regarding the large United States banks, boosting reserves against developing country loans and raising new equity tend to increase their inertia in participating in concerted debt-restructuring operations. However, money-centre banks present a large diversity regarding their ability to raise new capital and increase reserves. The combination of growing non-performing loans of domestic corporate clients and of the real estate market severely hurt profitability ratios. In particular, the profits of Citibank and Chase dropped during the third quarter of 1990, leading to a sharp decline in their stock values. For the United States banking industry as a whole, increased reserves, stronger capital ratios and declining developing country claims make banks increasingly reluctant to participate in new money transactions for developing countries as well as in debt-reduction schemes.

B. Treatment of loan-loss reserves

1. An overview of regulations concerning reserves

15. European banks initiated a first round of reserving against developing country bank claims as early as 1983 and 1984, under requirements of national banking supervision authorities. Tax incentives were provided to alleviate the cost of provisioning. A second round of reserving took place in the United States, when Citibank decided to boost loan-loss reserves in May 1987. All United States money-centre banks and the large United Kingdom clearing banks followed suit, owing to strong competitive pressure. A third phase of provisioning occurred during late 1987 and early 1988, when United States regional banking institutions initiated a very aggressive reserving policy, coupled with large sales of developing countries' assets. A last round of reserving took place after the announcement of the Brady initiative when United States money-centre banks decided to further strengthen reserves against developing country debt to about 50 per cent in the fall of 1989. Since then, banks such as Morgan and Bankers Trust raised their reserve level close to or up to 100 per cent of loans to developing countries. Citibank's reserve level, however, remains around 35 per cent of its exposure to developing countries.

16. Reserve levels are influenced by the treatment of loan-loss reserve in national regulatory regimes concerning whether the provisions are included in regulatory capital and how these are treated for tax purpose. Thus, in France and

the United States, country risk reserves are included in regulatory capital (in the tier-2 elements). In Japan, reserves are included in capital though in limited and carefully monitored amounts. In all other countries belonging to Organisation for Economic Co-operation and Development (OECD), loan-loss reserves against developing countries' debt are excluded from regulatory capital.

17. The tax treatment of loan-loss reserves has also an impact on portfolio management. In countries such as Canada, France, Germany and the United Kingdom, general loan-loss reserves are tax deductible. This encourages banks to reorganize capital base through provisioning rather than by selling their assets.

18. In Japan, the country risk reserves are tax deductible in an amount of 1 per cent. In the United States, loan-loss provisions are not tax deductible; only realized losses may be deducted. As actual charge-offs occur, taxes may be reduced, providing the opportunity to replenish reserves without additional charges against net income. In particular, specific mandatory reserves are tax deductible. A summary picture of regulations concerning loan-loss reserves is presented in table 2.

Table 2. Tax and accounting treatment of loan-loss reserves

Country	Provision levels (percentage)	Capital inclusion a/	Tax deduction a/
Canada	45	No	Yes (45)
France	58	Yes	Yes (60)
Germany	50-80	No	Yes
Japan	40	Yes (39)	Yes (1)
United Kingdom	65	No	Yes (50)
United States			
Regional banks	75	Yes	No
Money-centre banks	50	Yes	No

Source: Michel H. Bouchet, "Transnational banks and external indebtedness of developing countries", paper prepared for the United Nations Commission on Transnational Corporations, November 1990.

a/ Figures in parentheses are percentages.

2. Implications for debt-reduction negotiations

19. To the extent banks are allowed to recognize tax losses without disposing of their loans, they have little incentive to participate in voluntary debt-reduction operations. To the extent reserves are both tax deductible and included in regulatory capital, banks would have still less incentives to participate in debt-reduction schemes owing to the resulting upfront capital loss.

20. Commercial banks tend to choose between free riding, new money, and/or debt-reduction transactions, depending on a wide range of constraints and motivations, including long-term business interests, amount of exposure, corporate client networks and capital ratios. Other things being equal, large loan-loss reserves tend to make transnational banks more reluctant to participate in new money and debt-reduction transactions. Banks can more easily withstand further loss potential in developing country loans. Tax credits from reserves represent an additional strength to the banks. In Japan and the United States, however, banks do not fully capture these tax benefits, which require the losses to be realized. Accounting and tax benefits for the creation of loan-loss reserves will influence not only the amount of reserves but also the willingness and the ability of transnational banks to participate in debt-restructuring negotiations.

21. Where commercial banks are allowed to include reserves in capital (as in France and the United States), they will be reluctant to enter debt-reduction schemes owing to the related upfront capital loss. Buybacks and discount bonds will thus probably meet strong opposition from the creditor banks. These banks will tend to prefer par bonds with temporary reduced interest rates in order to stretch the accounting loss in the income statement over the life of the loan. Commercial banks which must reserve against new money credits (e.g., in France) will face an additional cost compared to banks which have the discretion of increasing or maintaining reserves at existing levels. Finally, banks which benefit from very limited tax deductions on loan-loss reserves (e.g., in Japan) will prefer selling discounted developing country claims in order to shrink their new money base and improve asset to capital ratios.

C. Treatment of debt-restructuring instruments

22. The preceding section has shown that transnational banks have made large provisions against claims on developing countries. In part, such high provisions resulted from accounting and tax incentive to strengthen loan-loss reserves, prompted by the desire to protect banks from overexposure. However, this is fraught with a perverse implication for debt reduction because high provisions encourage banks' inertia with respect to new money loans and/or participation in debt reduction. In consequence, regulatory provisions were modified by several creditor countries to facilitate the implementation of the new official strategy of debt reduction. The scope of the present report does not permit a comprehensive discussion of the various regulatory adjustments in different creditor countries. The salient features of these adjustments in selected creditor countries and their implications for future debt-restructuring agreements are described below.

1. France

23. The Banking Commission of the Banque de France stipulated that French banks should adopt a reserve level at least equal to the average provision level of the French banking community, currently about 55 per cent. Such an average level is considered like a minimum level. Regarding the accounting treatment of provisions held against debt-restructuring bonds, on 30 October 1989 the Banque de France stipulated that discount bonds do not lead to a drop in reserves as long as a bank's reserve level is below the banking community's average level. Likewise, new money credits do not require incremental provisions as long as a bank's reserve level is equal to or above the banking community's average level.

24. In November 1989, the Banque de France's Governor declared, however, that banks may make reserves against new money loans even if it implies reserves above the average level. New debt-restructuring instruments do not require additional loan-loss provisions as long as there is no major country risk deterioration. Par bonds do not lead to any decline in provisions, hence involve no upfront capital loss. Initially, the securities are recorded in the "transaction portfolio", where sales/purchases give rise to profits/losses which are lumped together in the end-of-year profit and loss statement, resulting in an adjustment in provisions. Securities held in the transaction portfolio must be marked to market. Banks may record the bonds at a later stage in the "investment portfolio" where bonds are kept until maturity and do not require provisions as long as the payment of principal is guaranteed. The value of the bonds at year-end is the lower of either the acquisition price or the market price. French banks have two years to decide where to hold the securities.

25. Debt-to-equity swaps, for accounting purposes, constitute a disposal of assets (so-called "cession"), with a resulting decline in developing country claim portfolio and a corresponding increase in equity participation portfolio. The tax treatment of equity holdings currently is less favourable than the treatment of loan-loss reserves.

26. Regarding the treatment of Mexico's debt-restructuring agreement, the Director of the Treasury agreed to make an exception to the normal tax rule in October 1989. Normally, collateralized debt-exchange offers should lead to recapturing provisions in the income statement. New provisions against securities would then be taxed at 19 per cent rate, compared to 34 per cent.

27. Regarding discount bonds whose principal is collateralized, the Treasury stipulated that excess provisions, i.e., above the discount or loss level, would be gradually recaptured and taxed over the life of the new instruments. In the case of Mexico's discount bonds, thus, provisions would be linearly recaptured over 30 years. In August 1990, the Director of the Treasury agreed that a similar tax treatment be applied to Venezuela's debt-restructuring agreement regarding collateralized bonds. Regarding par bonds, overall existing provisions must be gradually recaptured and taxed accordingly. Regarding new money credits, additional country risk provisions are established so as to reach an average level that is considered adequate by the Banque de France. Incremental provisions are tax deductible up to the maximum limit of 60 per cent.

28. The combination of tax deductibility and capital inclusion of reserves has proved to be a powerful incentive for constituting large and growing provisions against developing country exposure. Current reserve levels of the three largest banks stand at close to 60 per cent - that is, the maximum authorized level for tax deductibility. Within this global limit, however, bank management has the discretion of allocating loan-loss reserves in accordance with country risk assessment - that is, as long as the average reserves stand at 60 per cent. French banks' substantial loan-loss reserves have strengthened capitalization ratios due to the capital inclusion of reserves. However, large reserves might constitute disincentives to participate in new money and debt-reduction exercises for two reasons.

29. First, new money loans are taxed by incremental reserves and contaminated by secondary market discounts. According to French bank regulatory authorities, banks have to provision new money at the same level as existing exposure. The Banque de France does not recognize the implicit seniority of new loans vis-à-vis existing exposure. Refinancing arrangements, therefore, require similar ratios of loan-loss reserves as old claims. As a result, French banks will be reluctant to be "new money banks" in debt-restructuring and refinancing agreements.

30. Secondly, French banks face tax constraints regarding the debt-exchange offers that involve swapping existing loans for new bonds. In such an exchange, provisions on existing claims have to be recaptured in income and taxed accordingly. In addition, new provisions must be constituted against the bonds, though at a lower tax rate. The implicit seniority of bonds compared to loans, therefore, is not an element of much significance for inducing French banks to participate in new money exercises.

31. In a menu of debt-restructuring options, French banks might favour reduced-interest rate loans which will not materialize in capital losses but rather in accounting losses over the life of the new financial instrument. Thus, in the 1990 Mexico Debt Exchange Offer, Credit Lyonnais chose the par bond option for about two thirds of its exposure. Likewise, Indosuez opted for the par bond in order to stretch the accounting loss throughout the 30-year life of the instrument. Choosing discount bonds would have affected the capital ratio target, owing to the reserve inclusion in regulatory capital. Société Generale also opted for par bonds because the fixed rate and the stability of reserves were perceived as two major advantages compared to discount bonds and new money.

32. Several modifications in tax and accounting regimes of debt-restructuring transactions and new money agreements could facilitate the participation of French banks in debt-restructuring schemes. A differentiation between old and new claims, for accounting purposes, would encourage banks to join new money agreements. In addition, adjustments in the tax treatment of securities would remove current obstacles for swapping existing loans for bonds. Currently, provisions on securities receive less generous tax deductibility than loans. The decision of the Ministry of Finance to grant an exceptional treatment to securities issued by Mexico in the course of the 1990 Debt Exchange Offer has left some questions unanswered. In particular, uncertainty remains regarding the accounting treatment of Mexico's bonds in the year-end balance sheet. In normal accounting terms, bonds

should be registered on the basis of their market prices. Should a gap appear between existing provisions and market value, French banks do not currently know what will be the guidelines provided by the Banking Commission.

2. Japan

33. The Japanese authorities have limited the banks' ability to recognize tax losses on developing country loans. Accordingly, banks have incentives to participate in debt-reduction transactions in order to accelerate tax-loss realization. In addition, Japanese banks' high profitability and large (though rapidly eroding) hidden reserves might provide further incentives to accept sharing secondary market discounts with debtor countries. The ongoing appreciation of the yen vis-à-vis the dollar has also improved the developing country assets of Japanese banks to their reserve ratios by reducing developing country exposure as a percentage of equity and total assets. On a case-by-case basis, the Ministry of Finance has encouraged banks to participate in debt-restructuring agreements by allowing them to recognize losses for both accounting and tax purposes.

34. In the case of Mexico's Aztec bonds in March 1988, the banks were able to deduct losses from their tax liabilities and to avoid contamination of their portfolios regarding the portion of the loans not tendered. Thus, Japanese banks were allowed to sell their loans at a discount without revaluing the rest of their portfolios at the same discount, whether or not bank claims were tendered. In the case of buybacks in Chile and in Bolivia, the Ministry of Finance allowed a recognition of tax losses equal to the difference between the book value of the original loan and the value of the cash received.

35. In October 1989, the Banking Bureau and the International Bureau of the Ministry of Finance, in consultation with the Tax Bureau and the Securities Bureau, issued guidance regarding Mexico's par and discount bonds. According to these guidelines the Mexican bonds will be listed at the Luxembourg stock exchange. The acquisition price of the bonds shall be the first traded price at the exchange. If a bond is not traded for the time being, the indication price shall be the bond price. Moreover, the price difference between the original book value of the loan before being swapped for the Mexican bond and the acquisition value of the loan is recognized as loss for both tax and accounting purposes. In addition, the bonds received must be revalued annually in accordance with the banks' normal accounting method for listed securities. Thus, any subsequent drop in the market value of the listed bonds will lead to a loss for tax and accounting purposes. In the 1990 Mexico's restructuring package, Japanese banks' options were strongly in favour of discount bonds.

36. Regarding debt-to-equity swaps, the Ministry of Finance has liberalized regulations for secondary market transactions. Permission from the Ministry is still required for loan sales. Though banks may not participate directly in swaps, they may sell discounted loans to Japanese corporations for debt-to-equity conversion transactions. A joint factoring company, based in the Cayman Island, has been set up by 28 commercial banks for that purpose. The Ministry has provided tax incentives to encourage debt swaps in a subsidiary's capital.

37. Japan's Ministry of Finance has taken a case-by-case approach to voluntary debt and debt-service reduction. The Ministry has not disclosed the list of debtor countries for which loan-loss reserves must be created, though about 45 debtor countries reportedly are on the current list. The recognition of loan-losses results from specific negotiations between commercial banks and the regulatory authorities. On several occasions, the Ministry of Finance has provided the banks with flexible guidance for entering debt buybacks and debt conversion schemes, in particular in the cases of Bolivia, Chile, Mexico and Venezuela. The Ministry has also modified regulations for encouraging debt-to-equity swap transactions. Finally, the Cayman Island-based factoring company can be used as a channel for discounted developing country asset sales by Japanese banks, although within limits set by the Ministry. Remaining constraints on debt-reduction transactions stem from the differentiated tax and accounting treatment of discount and par bonds. Under current guidelines, interest-rate reductions would not normally result in the recognition of tax or accounting losses, while principal reductions would be more likely to lead to loss recognition.

3. United Kingdom of Great Britain and Northern Ireland

38. In February 1988, the Bank of England specified the accounting and regulatory treatment of Mexico's auction of bonds to be tendered at a discount. The Bank of England decided to treat the bonds as Mexican risk as to both principal and interest even though principal repayment on the 20-year securities was to be collateralized by a special issue of non-marketable securities of the Government of the United States. Bonds that were held for long-term investment would be treated like existing loans with provisions driven by the matrix of factors established by the Bank of England to determine the adequate level of loan-loss provisions. The three categories of factors are: the borrower's inability or unwillingness to meet its debt-servicing obligations; the nature of debt-repayment difficulties and the extent of the country's financial problems; and the likelihood of repayment problems either persisting or arising in the future. In January 1990, the Bank of England revised the matrix which provides the framework for assessing provisions against claims on developing countries and recommended higher levels of provisions.

39. The Bank of England specified the treatment of Mexico's debt-restructuring instruments for the 1990 financing package. The discount bonds should be placed on bank books at face value, that is, at 65 per cent of the original face value of the bank loans. The difference between the booked and the original face value should be charged to provisions. An additional charge to income would only be required if the loss exceeds the original level of provisions. In addition, the supervisory authorities stated that no additional provisions would be required against the discount bonds, unless Mexico's economic and financial situation deteriorates in the future. In the case of par bonds, banks may record the bond at its face value and no additional provisions are required unless there is a further deterioration in Mexican risk.

40. The Inland Revenue has specified that developing country loan-loss reserves are tax deductible on the basis of the estimated amount of losses. By contrast, securities (including bonds) are normally taxed on a realization basis. Thus,

losses on such securities would not be recognized for tax purposes until the assets are sold.

41. In the case of Mexico's 1990 debt restructuring, the Inland Revenue stated that discount bonds would be booked at face value and that difference between the value of the original loan (that is, 100 per cent) and the value of the bonds (that is, 65 per cent) would be deducted. Par bonds should be booked at face value, less a provision calculated on the basis of the net present value of the funding cost over the life of the bond, that is, 30 years.

42. Because loan-loss provisions are not included in regulatory capital, United Kingdom banks do not face an upfront capital loss in exchanging existing claims for discount bonds nor for cash in discounted repurchase operations. Provisions are tax deductible within limits set by the Inland Revenue. Banks face limitations on allowable tax losses in discounted debt exchanges in the inter-bank secondary market unless they participate in debt buyback operations for the benefit of debtor countries. For accounting purposes, the regulatory authorities do not differentiate between new money loans and existing exposure. As a result, United Kingdom banks must establish incremental loan-loss provisions on new loans on the basis of the matrix. In addition, the matrix does not differentiate risk according to the implicit "seniority" and servicing track record of particular financial instruments, with the exception of short-term trade lines. New money bonds, therefore, do not receive any special status. Finally, the matrix does not facilitate developing countries' return to market access since it provides a large negative score to countries which have rescheduled at any time since January 1983. Adjustments in the matrix with a view to differentiating debtor countries regarding future ability to service debt-payment obligations and not purely past behaviour would clearly encourage new money credits.

4. United States of America

43. An important part of the 1990 agreement between the banks and Mexico provided that the loan-to-bond conversion would take the form of a debt-exchange offer. Neither type of bond would be subject to the sharing clauses that are standard in most syndicated loan agreements. The agreement provided for a comprehensive rescheduling of all eligible medium- and long-term bank debt. Accordingly, debt held by creditors participating in the financing package would not be subject to pro rata sharing clauses with debt held by banks not participating. In that sense, the 1990 pact created a "legal novation" with respect to previous agreements between Mexico and the commercial bank creditors.

44. For the United States banks, exchanging loans for discount bonds would normally lead to a reserve decline equal to the difference between the face value of the debt and the discount, hence an upfront capital loss owing to the inclusion of reserves in regulatory capital. Thus, in the case of Mexico's 1988 "Aztec bonds", United States banks were required by the Security and Exchange Commission to fair value the bonds received in the auction and to write down all loans offered for exchange to the tender price, implying a substantial capital loss for banks participating in the exchange transaction.

45. For accounting purpose, the Federal Reserve Board and the Security and Exchange Commission accepted to consider Mexico's later debt restructuring as an "exchange offer" under the framework of Financial Accounting Standards Board Statement No. 15 (or FASB 15). In particular, it was stipulated that where a transaction can be categorized as a "troubled debt restructuring" under FASB 15, banks need not necessarily recognize a capital loss upon participating in voluntary debt reduction. FASB 15 defines a "troubled debt restructuring" as a restructuring of bank claims in which the creditor grants a concession to the debtor owing to the debtor's financial difficulties. The concession may make the form of an interest rate reduction, the extension of maturity dates, a reduction of principal, or debt-exchange offers, including debt-equity swaps.

46. The Security and Exchange Commission recommended the application of FASB 15 as appropriate accounting treatment of Mexico's debt restructuring for both discount and par bonds, because both transactions involve concessions granted due to the debtor's financial difficulties. In particular, the Security and Exchange Commission stipulated that a loss is recognized only if the total future undiscounted cash receipts under the new terms of the loan, including both principal and interest payments, are less than the book value of the loan. Because of the 30-year collateral of the bonds' principal and a positive nominal interest rate, such criteria were met by both the par and discount bonds.

47. In the United States, loan losses associated with sovereign risk credits are permitted full tax deductions only when loans are sold or when a country's loans have been deemed value impaired and an allocated transfer risk reserve has been mandated by regulators. The effective tax deductibility of losses depends on two factors.

48. First, tax loss is granted only if a transaction triggers a realization of the loss. Thus, the cash sale of an asset, the partial or complete charge-off, or an exchange for a different asset will realize a loss. Secondly, a bank should have available taxable income against which the loss can be offset to achieve either a reduction in taxes currently payable or a refund of taxes previously paid. If the realized loss in a given year exceeds taxable income, banks can "carry back" the resulting net loss against tax returns up to 10 years prior or "carry over" the loss against tax returns 5 years ahead and obtain refunds.

49. The 1990 Mexican Financing Package raised a number of tax issues related to par and discount bonds. The Internal Revenue Service issued a ruling (IRS Revenue Rule 89-122) stating that both bonds represent a material change in the terms of the obligations which lead to an exchange for tax purposes. If the bond is "publicly traded" within the meaning of the Internal Revenue Code, then it must be recorded at its fair value for tax purposes. Should the bond not be "publicly traded", it must be recorded at its issue price which is the lesser of the face amount of the new instrument or the present value of the debt instrument using the "applicable federal rate" as the discount rate.

50. The Internal Revenue Service gave mixed signals to the United States banking industry regarding support to the debt strategy. In May 1989, the Internal Revenue Service announced limits on the tax breaks banks can get on losses on developing

country loans. Under this ruling, foreign loan losses are only deductible against foreign loan income. Until then, banks were allowed to reduce their taxable income by subtracting foreign loan losses from both foreign and domestic loan income.

51. The tax treatment of debt-equity swap transactions has been specified by the IRS ruling 87-124. The tax rule differentiates between three types of transactions for tax purposes:

(a) In a discounted sale on the secondary market to a private investor, a bank can recognize a tax loss equal to the difference between the face value of the asset and the amount received from the purchaser;

(b) In a debt-conversion transaction in which a bank directly tenders an obligation to the debtor country's central bank, the bank may recognize a loss equal to the difference between the fair market value of the equity investment and the face value of the assets;

(c) In a debt-conversion transaction for the benefit of a charitable organization, a bank can realize a loss on the exchange of the debt equal to the difference between the face value and the fair market value of the local currency proceeds of the conversion. In addition, the bank is entitled to tax relief admissible to a charitable contribution which will be considered to be equal to the fair market value of the conversion.

52. To the extent that a United States bank seeks to acquire for its own account an equity interest in a company located in a debtor country, regulations restrict the extent of the bank's ownership interest in the local enterprise. In particular, banks are subject to the restrictions on equity investments contained in Regulation K issued by the Federal Reserve Board. Regulation K limits banks to investments and activities outside the United States that are "of a banking or financial nature". The Board has relaxed the restrictions of Regulation K in the context of debt-equity swap transactions in developing countries. Prior to these amendments, the regulation posed a significant obstacle to United States banks acquiring large equity positions in foreign non-financial companies.

53. In recent years, the Board amended Regulation K twice. The first amendment in August 1987 permitted United States banking organizations to acquire up to 100 per cent of the shares of a foreign non-financial company under several conditions:

(a) The company is acquired from a foreign Government;

(b) The country has restructured its sovereign debt obligations to foreign creditors since 1980;

(c) The ownership interest in the company is divested no later than five years from the date of acquisition;

(d) The investment is held through a bank holding company.

Effective February 1988, the Board further amended Regulation K to permit banking organizations to make investments up to 40 per cent of the shares of any private sector company in a heavily indebted country through debt-equity swaps.

54. On 1 May 1985, the Comptroller of the Currency issued a circular governing the accounting treatment of capitalization of interest on loans. Capitalized interest is defined as uncollected interest which is added to unpaid principal in accordance with the contractual loan agreement. The circular provides that interest capitalization would not be permitted if loans are classified by the examiners as loss, doubtful, value impaired or non-accrual.

55. As a result of more flexible accounting and tax guidelines, United States banks may capture tax benefits through loss realization, thereby facing a more favourable regulatory environment for implementing debt-conversion transactions, such as debt-to-equity, debt-for-nature and debt-for-exports swaps.

56. However, the new tax ruling restricts banks from deducting foreign credit losses from domestic loan income. This ruling in effect reduces the amount of foreign tax credits available in a given year to banks that write down foreign loans. The reaction of United States banks was that the Internal Revenue Service ruling would make banks still more reluctant to participate in the Brady initiative.

57. Besides, the strict guidelines of United States regulators for interest capitalization prevent United States banks from capitalizing uncollected interest payments in lieu of new money. As a result, interest capitalization in debt-restructuring agreements has become a less viable option for United States commercial bank creditors.

III. SUGGESTIONS FOR FURTHER ACTION

58. As noted before, the substantial reduction of the debt of developing countries during the past few years has been facilitated by flexible regulations regarding debt exchange, discounted sales and debt-equity transaction. However, the need for further modifications remains. Some suggestions have been offered in the context of regulatory changes in specific creditor countries discussed in the preceding chapter. Additional suggestions for further reforms are described below.

A. Risk-weighted capital guidelines

59. The new international capital guidelines of the Bank for International Settlements will have a major impact on transnational banks' asset portfolio management with implications on developing countries' access to capital markets and debt reduction, for several reasons:

(a) Even for those countries which have maintained access to the international capital markets, the new guidelines make bank lending more expensive in terms of capital backup, since a 100 per cent risk weight is applied to all long-term claims on all developing debtor countries. The provision of new money to

developing countries is, therefore, more expensive. The assignment of uniform 100 per cent risk weight to all developing countries deserves review;

(b) The guidelines do not differentiate between developing countries according to credit-worthiness criteria. Thus, all developing countries are included in the same category irrespective of their past performance record. This implies higher costs of funds because bank creditors will require higher spreads to offset the relatively higher risk weight. A distinction between debt-restructuring and debt-refinancing countries would preserve market access for those countries which have kept servicing their external liabilities;

(c) The new capital guidelines impose a limited inclusion of loan-loss reserves in capital by the end of 1992. While specific reserves are excluded from regulatory capital, general reserves may be included in amounts up to 1.25 per cent of risk assets. For capital weak banks, this limited inclusion will mean that they have to improve their capitalization through additional equity, sales of assets, or portfolio restructuring. On the other hand, for banks which include reserves in capital without limitation, as in France and United States, capital inclusion tends to make banks unwilling to agree on discounted debt-exchange offers owing to the related upfront capital loss. The rationale for including general loan-loss reserves in regulatory capital is that non-allocated provisions amount to quasi-capital which can provide a cushion against unexpected loan losses. Where reserves are included in capital, regulators might support timely debt-reduction agreements by removing the capital inclusion of reserves in case of protracted debt negotiations.

B. Tax deductibility of discounted asset sales

60. With large and growing loan-loss reserves against developing country exposure, transnational banks can more easily withstand protracted arrears. Instead of providing new money credits or participating in discounted operations, banks might prefer holding their reserved assets or entering portfolio rebalancing transactions in the interbank market.

61. Regulators might provide additional incentives to commercial banks for participating in debt-reduction operations for the benefit of developing countries with official support. Thus, in the spring of 1990, the United Kingdom's tax authorities decided to provide full tax relief only for developing country asset sale transactions which lead to actual debt relief for the debtor countries. A full realization of the loss for tax purposes would not be granted for inter-bank developing country asset sales on the secondary market of commercial bank claims. This would allow debtor countries to share the discount with their commercial bank creditors. Similar decisions by other creditor countries could encourage a greater participation of transnational banks in providing additional debt relief to debtor countries.

C. Distinction between purposes of credit

62. The appropriate level of country risk provisions should be related to the relative riskiness of an asset and its degree of ultimate collectibility. In practice, transnational banks determine their provisioning level against their total developing country exposure, whatever the nature of the claims. In France, for instance, banks determine reserve levels against both long- and short-term claims, including trade credits which are normally serviced. Bank regulators might isolate revolving trade lines and specific-purpose financing instruments from doubtful loans in order to preserve debtor countries' access to voluntary financing flows.

63. Similarly, bank regulators do not differentiate new money loans from existing developing country assets for accounting purposes. For example, in Canada and in France, banks are expected to build additional tax deductible reserves against new money credits to developing countries. New money credits could be considered as requiring less provisions than existing assets. Despite the limited tax deductibility of reserves against new money credits, provisions tend to make new credits more expensive and hence discourage banks from participating in cash-flow relief transactions.

D. Accounting penalties for free-riding banks

64. In new money and debt-reduction negotiations, a crucial issue is the level of bank participation in a debt agreement. Following completion of an agreement between a country and its bank steering committee, a telex is sent to the entire community of bank creditors for approval. Small exposure banks which do not have long-term business interests in a country and which have large provisions, tend to be reluctant to increase exposure or to accept income or capital losses. Accordingly, refinancing agreements can be delayed for several months because of a few recalcitrant banks. Thus, in the case of Columbia's 1988 refinancing agreement, only 112 out of about 175 creditor banks signed the new agreement, thereby forcing large banks to increase their share so as to offset the exit of small banks.

65. Bank regulators could stimulate participation in debt-relief exercises by requiring non-participating banks to increase non-tax deductible reserves against developing country claims.

E. Coordination

66. Regulatory differences among creditor countries, some of which have been detailed in the preceding chapter, make it a formidable task for debtor countries to formulate a debt-reduction package that has a similar impact on all creditor banks. This imposes a severe constraint on securing a consensus on any package and makes negotiations a protracted and time-consuming process. Hence, the need for closer coordination among creditor countries in formulating regulations that can facilitate debt reduction.

CONCLUDING OBSERVATIONS

67. The earlier debt strategy associated with what is known as the Baker Plan was essentially centred on the provision of additional money. The implicit stipulation was that the debt problem was primarily one of illiquidity and the provision of new money could buy the time needed to get over the temporary crisis. But the prolonged nature of the problem, coupled with the fact that new money contributions by transnational banks did not materialize, brought about a major shift in the debt strategy in favour of debt reduction.

68. The present report has shown that, notwithstanding some significant debt reduction, facilitated by regulatory adjustments in creditor countries, there is no reason to be complacent about the debt problem. Against this background, the report has examined the implications of regulatory modifications for future debt-reduction efforts with reference to selected creditor countries. The report has also identified some general areas which require regulatory authorities' urgent attention in order to facilitate further debt and/or cash-flow relief for the debtor countries.

69. The analysis in this report has shown that there are differences in the regulatory frameworks among different creditor countries giving rise to different incentives for their transnational banks to participate in debt reduction. It has not been possible to examine in any detail the differences in the extent of participation of banks from various creditor countries in debt-reduction measures in response to differential incentives. Further research in this direction could provide very useful insight regarding the impact of regulatory changes on transnational banks' participation in debt-reduction efforts.

70. It should also be emphasized that regulatory modifications are no more than enabling in nature. In other words, they can, if suitably formulated, generate a set of incentives for transnational banks to be more willing participants in debt-reduction/cash-flow relief transactions. But these would have to be supported by a greater commitment on the part of political authorities in creditor countries in order to ensure that their transnational banks respond vigorously to the incentives offered through regulatory adjustments.

Notes

1/ Official Records of the Economic and Social Council, 1990, Supplement No. 6 (E/1990/26).

2/ "Transnational banks and external indebtedness" (E/C.10/1990/11), p. 8.

3/ Michel H. Bouchet, "Transnational banks and external indebtedness of developing countries", paper prepared for the United Nations Commission on Transnational Corporations (1990), p. 9.

Notes (continued)

4/ World Bank, World Debt Tables 1989/90, vol. I (Washington, D.C., 1990), p. 13.

5/ Michel H. Bouchet, op. cit., p. 5.

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ROLE OF TRANSNATIONAL CORPORATIONS IN SERVICES, INCLUDING TRANSBORDER DATA FLOWS: ROLE OF TRANSNATIONAL BANKS

Transnational banks and debt-equity conversions

Report of the Secretary-General

SUMMARY

Debt-equity swaps have been implemented by debtor countries as one of an array of measures to reduce the stock and servicing cost of external debt. But the reduction of debt is not the singular, and in most cases, not even the most important objective sought to be promoted through this mechanism. Among the other objectives are to stimulate foreign direct investment, channel investment into desired industries or geographical areas, capture a portion of the secondary market discounts and minimize such negative consequences as inflationary pressure and "round-tripping".

The evaluation of country experiences in the present report suggests that debt-equity swaps have brought about a significant debt reduction in only one country (Chile). They appear to have induced additional foreign direct investment in most countries, directly or as a catalyst, although the quantitative magnitude of additionality is difficult to calculate. Governments have largely succeeded in channeling swap investments into desired sectors or geographical areas and in

* E/C.10/1991/1.

capturing a significant portion of discounts where policies were designed towards those ends. The long-term impact of swaps on the balance of payments is ambiguous, and measures taken to contain inflationary pressure or round-tripping involve trade-offs with other objectives.

The present report suggests that there are certain inherent trade-offs among the objectives that debt-equity swap programmes are intended to serve. The design of programmes should, therefore, be based on a clear definition of priorities. Furthermore, debt-equity swap should be viewed as only one of the policy tools in economic management and in debt reduction. A failure in the appropriate choice of other tools could thwart the success of debt-equity swap programmes as well.

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INTRODUCTION

1. At its sixteenth session, the Commission on Transnational Corporations adopted a resolution in which the Secretary-General was requested to prepare an analytical report on debt- equity swaps and the effects that such swaps could have on foreign direct investment and the overall development of host countries, taking into account the experience of countries that have adopted those schemes. 1/ The present report has been prepared in response to that request.

2. Since the onset of the debt crisis, various mechanisms of debt conversions have evolved to reduce the stock and servicing cost of debt owed to transnational banks by developing countries. 2/ Debt-equity swaps are one of those mechanisms. (The terms "debt-equity swaps" and "debt-equity conversions" have been used interchangeably in this report.) It is a process by which a debt instrument of a debtor country is converted into an equity investment in that country. This involves several steps. Typically, an investor wishing to invest in a debtor country through debt-equity swaps presents an investment proposal to the competent authorities. On approval, the investor purchases the foreign debt of that country, generally owed to a transnational bank, at a price less than face value from the secondary market. The debt paper is then presented for redemption to the debtor country's central bank, which provides local currency equivalent to somewhere between the face value and the secondary market value of the paper. The investor then uses the local currency to make the approved investment. Within this overall framework, the content of individual country programmes may differ significantly. Debt-equity swaps have been implemented in many countries in one form or another. Among these are countries as diverse as Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Jamaica, Mexico, Nigeria, the Philippines and Yugoslavia.

3. In consonance with the above-mentioned resolution of the Commission, the present report focuses upon the impact of debt-equity swaps on development. A detailed analysis of debt-equity programmes and their major features is contained in a recent publication of the Centre. 3/ Quite apart from the explicit purpose of reducing debt, debt-equity swaps are implemented by debtor countries to promote a number of other objectives which include both the promotion of benefits and the avoidance or minimization of costs. It should be emphasized that these objectives and, even more so, the relative weight attached to different objectives, vary among countries. The present report analyses selected aspects of the impact of debt-equity swaps on development. The report draws heavily, but not exclusively, from case-studies of Brazil, Chile, Mexico and the Philippines recently undertaken by the Centre on Transnational Corporations and its Joint Unit in the Economic Commission for Latin America and the Caribbean (ECLAC). The rationale for the selection of these countries is that they accounted for over four fifths of the total debt-equity swaps in 1989.

4. The analysis in this report shows that debt-equity swaps can make some contribution to the reduction of debt. But its quantitative significance in relation to the volume of debt has remained limited in most countries. The implication is that this mechanism should be viewed as just one in a menu of

options to provide debt relief and cannot be relied upon as a single instrument. Under appropriate circumstances, it can also be a useful tool to induce foreign direct investment. However, there are severe problems in measuring the contribution of debt-equity swap programmes, in their own right, to foreign direct investment inflows. Besides, there are many inherent trade-offs in the design and implementation of debt-equity swap programmes. An awareness of these limitations is of critical importance for countries considering the institution of new debt-equity conversion programmes or a revision of old ones.

I. THE OBJECTIVES OF DEBT-EQUITY SWAPS

5. As noted above, debtor countries implement debt-equity swap programmes for different purposes. Moreover, the importance assigned to different objectives varies across countries and over time within the same country as the consequences of implementation are evaluated. Some of the most commonly cited objectives of debt-equity swap programmes are:

(a) Reduction of the burden of external debt;

(b) Stimulation of foreign investment and thereby flow of technology and skills;

(c) Encouragement of the return of flight capital, that is, capital held abroad by residents of the debtor country;

(d) Channelling investment into desired industries, in particular, export-oriented activities or into preferred geographical areas;

(e) Capturing a part of the discount at which the debtor countries' debt instruments are traded in the secondary market;

(f) Reduction of the pressure on the balance of payments;

(g) Support to programmes of privatization of state enterprises.

6. Debtor countries also recognize that the implementation of debt-equity swap programmes is fraught with a number of adverse consequences. One of these relates to additionality of foreign investment. The key question here is whether the programme induces additional investment or simply provides a subsidy to investments that would have come anyway. A second concern relates to "round-tripping" whereby foreign currency is brought in from the outside or purchased from the parallel market in order to acquire foreign debt obligations at a discount, subsequently redeemed in local currency, converted back into foreign currency and taken out. Among the other adverse consequences are the potential inflationary impact of debt-equity swap programmes and the inequity involved in subsidizing foreign investors, more so when residents are excluded from participation. 4/

II. THE POLICY FRAMEWORK

7. In order to maximize the benefits and to minimize the harmful consequences of debt-equity swaps, debtor countries usually lay down detailed policy guidelines for implementation. The regulations touch upon a variety of issues. In all countries, debt-equity swap investments are treated somewhat differently from regular investments. Regulations on swap programmes generally define the eligible investors and the purposes of the investment, set explicit priorities in terms of the sector or the geographical area in which swap resources may be invested, establish restrictions on profit remittance and capital repatriation or require fresh money.

A. Eligible investors

8. An important issue is the extent to which debtor countries allow both nationals and foreigners to participate in their debt-equity swap programmes. While in some countries only foreign investors are allowed to take advantage of the swap incentive, in others local residents are strongly encouraged on the grounds that the scheme provides incentives to repatriate flight capital.

9. Chile and the Philippines, for example, have allowed participation of their nationals from the outset of their swap programmes. There are some questions as to whether transactions under chapter XVIII, the principal vehicle for participation of nationals in debt swap programmes in Chile, should be treated as debt-equity swap. The reason is that there is no legal stipulation that nationals have to use local currency proceeds of swaps under chapter XVIII in equity investments. On the other hand, some part of these proceeds has been actually used in equity investments. Moreover, an annex added to chapter XVIII in 1986 contemplated that nationals could apply to the central bank for case-by-case authorization to convert an eligible debt instrument owned or guaranteed by a Chilean corporation, including a financial institution, into equity in the same corporation. For the purpose of discussion in the present report, transactions under chapter XVIII in Chile have been treated as debt-equity swaps, unless specifically noted otherwise. In Mexico, during the first phase of its swap programme between 1986 and 1987, eligibility was extended only to foreign investors. Although in March 1987, nationals were allowed to participate in swap activities, the Government never included that right in its regulations governing swaps, suggesting that it had reservations about opening the programme to domestic investors. When Mexico reinstated its swap programme in 1990, new regulations allowed both domestic and foreign investors to participate under the auction system. In Venezuela, where only foreigners were allowed to participate in swap transactions under Decree 1521/2485 of April 1987, the Government modified the regulations in March 1989 (Decree 86) to open the swap programme to national investors.

10. The participation of local capital in swap schemes may have positive and negative impacts on debtor nations. On the positive side, the encouragement of participation by nationals helps to avoid the denationalization of the economy and reduce the future foreign exchange costs of swaps. In Brazil, where local residents were not allowed to participate, the swap scheme was subjected to the criticism that it represented a discriminating subsidy to foreign investors.

11. On the negative side, the participation of domestic investors may lead to round-tripping, a process described earlier. Chile has attempted to minimize such practices by controlling the monthly volume of allowable debt-equity swaps by nationals. In the case of the Philippines, it was recognized that the resident investors (who accounted for nearly two fifths of investment through debt-equity swaps as of June 1990) were in effect able to acquire their foreign exchange requirements from the banking system as local banks were allowed to use their own foreign exchange reserves to buy convertible debt. However, since November 1987, this practice has been severely restricted by the central bank. 5/

B. Investment priority and restrictions

12. While some countries have been explicitly liberal with their swap schemes, others have established strict regulations regarding the use of swap funds and the sectors of the economy in which they can be invested. In all countries, however, profit remittances and the repatriation of capital attributable to investment through swaps are subject to special restrictions.

13. Thus, for example, the debt-equity swap programme in Brazil was subject to several restrictions. One half of the auctioned conversion quotas was to be directed to projects in underdeveloped areas. Furthermore, one condition that was unique in Brazil was the stipulation that swap funds could not be invested in a company which had repatriated capital within three years prior to the swap, unless the equivalent of capital was brought back into Brazil. Swaps could be used in new ventures, plant expansions, capitalization or the purchase of shares in national companies. But foreign investors appear to have been using swaps mainly to invest in existing firms and to expand subsidiary operations. 6/ The swap programme was suspended in January 1989.

14. In Chile, all foreign direct investments associated with debt-equity swaps under Chapter XIX have been undertaken within the context of the existing liberal foreign investment statute, the Decree Law 600 (DL600) of 1974. Thus, between 1985 and 1989, with the exception of oil and gas, nuclear energy and related raw material, all areas of the economy were open to debt-equity swaps. The only constraint a foreign investor in Chile faced in those years was that profit remittances were prohibited for the first four years and capital repatriation for ten years. The country's liberal debt-equity swap policy has been particularly singled out for criticism on the grounds that it resulted more in the subsidization of foreign purchases of existing assets than in the creation of new investments. In this context, it has been noted that the sale of state enterprises amounting to $658 million accounted for 25 per cent of all Chapter XIX operations until mid-1989. 7/ Chile instituted major policy changes for Chapter XIX in April 1990. Under the new debt-equity swap guidelines, the priority of the Government is no longer the fast reduction of the foreign debt but an improvement in the quality of investment. Another reason for stricter guidelines is that there has been a considerable decline in the supply of Chilean debt paper eligible for conversion. Henceforth, debt-equity swap investments will be restricted to new enterprises or the expansion of those existing ones which entail exports or import-substituting activities. In addition, some industries are now ineligible, including those

that are considered a "haven" for transnational banks, such as pension funds and insurance companies.

15. Under its debt-equity swap programme, Mexico permitted fairly wide use of swaps between 1986 and 1987, including for financial restructuring. A large number of investors used the option to retire debts owed to others by their local subsidiaries. Almost 25 per cent of the total value of swaps in 1986 and 1987 was used for financial restructuring. 8/ It should be noted, however, that in those operations, swaps improve a company's balance sheet but do not alter production facilities. Mexico reinstated its debt-equity swap programme in 1990, with major changes, as part of the 1989 negotiations between creditor banks and the Government under the aegis of the Brady programme. Swap operations have now been restricted to infrastructure projects and projects involving the privatization of public enterprises.

16. The Venezuelan debt-equity swap programme has also been subject to special restrictions since its outset in 1987. In June 1990, new regulations were issued restricting swaps to five priority industries: petrochemicals, aluminium, pulp and paper, tourism and infrastructure. Under the new Decree, swap funds can be used only to finance the local component of the project cost, and investors are expected to employ fresh funds for the imported component.

C. Debt-equity swaps and fresh money requirements

17. There are some countries in which it is stipulated that investments cannot be entirely financed through debt-equity swaps. Argentina now requires that 30 per cent of the total project cost be in the form of fresh funds; the requirement till 1987 was 100 per cent of the value of a swap. In Mexico, swap resources for the purchase of privatized state enterprises can be used to finance up to a maximum of one half of the purchase price. In Peru, only 70 per cent of the local costs of a project can be funded with debt-swap proceeds. The Philippines has varying rules of fresh money requirements, ranging from 0 to 60 per cent, depending upon the priority attached to an investment and the fees paid to the Central Bank. In Venezuela, a maximum of 30 per cent of the project may be financed with swap resources, except for investments in tourism where the maximum is 50 per cent. Furthermore, the prospective investor must deposit a 5 per cent surety bond (guarantee) to ensure that swap funds are invested as planned (to avoid round-tripping). Finally, the President and the Cabinet of Venezuela must approve all projects individually. 9/ A summary of the regulations is presented in table 1.

Table 1. Summary of principal features of debt-equity swaps of major developing country debtors

Country	Eligible debt	Eligible investors	Priority investments	Acceptable uses	Fresh money	Restrictions on repatriation of capital	Dividends/ profits	Exchange rate	Allocation of quotas
Argentina	Public sector	National and foreign	Priority given to investment that increases productive capacity in in the export sector	New investment, plant expansion, privatization (1990)	30 per cent	10 years	4 years	Parallel rate	Auction
Brazil (suspended in January 1989)	Private sector and state enterprises	Foreign	Priority given to projects in undeveloped areas	New investment, or expansions and shares in investment funds	None	12 years	-	Official rate	Auction
Chile	Public and private	National and foreign	Not specified (1985-1989); exports or import substitution industries (1990)	New investment plant expansion, acquisition financial restructuring (1985-1989); new investment, expansion (1990)	None	10 years	4 years	Official rate	Administrative decision under Chapter XIX and auction under Chapter XVIII
Mexico	Public	National and foreign	Privatization, exports, job creation, up-to-date technology, target zones (1986-1987); restricted to infrastructure projects and privatization (1990)	New investment, plant expansion, privatization and restructuring (1986-1987)	None (1986-1987); 50 per cent of the price of a divestiture (1990)	12 years	5 years	Parallel rate (1986-1987)	Administrative decision (1986-1987); auction 1990
Philippines (suspended in 1988)	Public	National and foreign	Export-oriented enterprises and sectors in need of revitalization	New investment, expansion, privatization	Varying scales	3 years (priority); 5 years (non-priority)	4 years	Official rate	Administrative decision
Venezuela	Public	National and foreign	Export promotion and import substitution in capital goods, chemical products, electronics, agriculture, agri-business, (1987-1989); petrochemicals, aluminium, pulp, carbon, tourism and infrastructure (June 1990)	New investment, expansion	A maximum of 30 per cent of the project may be financed by swaps, except for investment in tourism where the maximum is 50 per cent	5 years	10 per cent for 3 years; more thereafter	Official rate	Administrative decision; auction since March 1990

Source: United Nations Centre on Transnational Corporations, based on national sources.

/...

III. THE IMPACT OF DEBT-EQUITY SWAPS

A. Debt reduction

18. In an earlier study of the Centre it was observed that debt-equity swaps, while making a noteworthy contribution, could not resolve the debt problem. 10/ Under the best of circumstance, the likely volume of swaps would still be small in relation to the total volume of debt outstanding with transnational banks. This situation continues to hold. It is estimated that total debt conversions in 1990 were of the order of $21 billion, of which debt-equity swaps would account for $9 billion, contrasted with an estimated volume of transnational bank claims amounting to $246 billion of 20 severely indebted middle income countries. 11/ It should be noted here that the debt-equity swap figure for 1990 represents nearly double that of 1989, a year which saw a considerable deceleration over the previous year. Nevertheless, it is apparent that even a significant acceleration in debt-equity swaps can only make a small dent in the continuing burden of the debtor countries. Evidence to this effect is provided in table 2. This table reveals that, between 1986 and 1990, debt-equity swaps yielded a debt reduction in the order of $9.5 billion in Brazil (with the bulk of it in 1988), $6.5 billion in Chile, $4.1 billion in Mexico and $0.8 billion in the Philippines.

19. It is apparent that, with the exception of Chile, the cumulative value of debt reduced through debt-equity swaps is small in relation to debt owed to transnational banks. Chile has erased almost $10 billion of its foreign debt between 1985 and 1989, a large part of which, as noted above, has been contributed by debt-equity conversion. Chilean debt is, of course, small in relation to that of Brazil and Mexico. Yet, it is comparable to the size of the debt of the Philippines where the debt-equity swap mechanism played a minor role in the country's otherwise significant debt reduction ($4 billion between 1986 and 1990).

20. It should be noted that, to some extent, this observed impact is in consonance with the underlying policy priorities of the countries involved. An analysis of the case-studies suggests that Chile is the only country (among the four listed in table 2) where the reduction of debt was assigned the highest priority in implementing its debt-equity swap programme. This policy priority was backed up by a very generous attitude towards the use of debt-equity swap proceeds till 1989, as noted in the preceding section.

Table 2. The quantitative significance of debt-equity swaps in selected developing debtor countries, 1986-1990

(Millions of US dollars)

Country	1986	1987	1988	1989	1990
A. Stock of debt owed to transnational banks					
Brazil	61 027	63 152	59 539	56 811	59 216
Chile	14 484	13 287	10 978	...	...
Mexico	72 188	75 814	63 833	57 875	...
Philippines	15 120	14 504	12 940	11 945	11 128
B. Interest payments on account of debt to transnational banks					
Brazil	5 866	2 049	7 957	3 070	...
Chile	1 660	1 400	1 000	900	...
Mexico	7 991	7 543	7 009	6 308	...
Philippines	1 351	1 185	1 103	1 137	1 137
C. Volume of debt stock reduced through debt-equity swaps					
Brazil a/	206	347	6 912	1 572	478
Chile b/	569	1 528	1 834	1 733	574
Mexico c/	398	1 913	1 121	731	...
Philippines	16	266	317	189	55

Source: United Nations Centre on Transnational Corporations, based on case-studies and other international sources.

a/ Including informal swaps in the amount of $4,278 million between 1988 and the first half of 1990.

b/ Chapters XIX, XVIII and DL600.

c/ Figures do not include informal swaps.

B. Debt-equity swaps and foreign direct investment

1. Aggregate flow of foreign direct investment

21. In the four countries for which case-studies were conducted, debt-equity swaps (excluding debt-equity conversions by residents) have functioned as a significant vehicle for foreign direct investment, accounting from one fifth to four fifths of total flows in different countries (table 3). Furthermore, with the exception of

Table 3. Total foreign direct investment and foreign direct investment financed through debt-equity swaps

(Millions of US dollars)

Country	Total foreign direct investment inflow 1980-1984	Total foreign direct investment inflow 1985-1989	Foreign direct investment through debt-equity swaps a/ 1985-1989	Foreign direct investment through debt-equity swaps as percentage of total foreign direct investment 1985-1989
Argentina	2 195	3 646	731	20
Brazil b/	10 499	7 687	4 529	59
Chile c/	1 210	3 947	3 160	80
Mexico	7 497	10 098	3 052	30
Philippines	196	2 306	473	21

Source: UNCTC/ECLAC Joint Unit, based on IMF balance of payments data and national sources.

a/ Includes only that portion of swaps which corresponds to foreign direct investment.

b/ Excludes informal conversions.

c/ Excludes chapter XVIII transactions.

Brazil where the programme was discontinued in 1989, all these countries have experienced a greater inflow of foreign direct investment during the period 1985-1989 when debt-equity swap programmes were in force, compared to the immediately preceding five-year period. In Brazil, the volume of foreign-direct-investment inflows during the period 1985-1989 would fall short of that in 1980-1984, even on the assumption that the volume of debt-equity swaps in 1989 was the same as in 1988 when the peak was reached, that is, if the difference between 1988 and 1989 volumes of formal debt-equity swaps amounting to $2,744 million were added to foreign direct investment figure of the period 1986-1989. However, the experience of other countries gives rise to the presumption that debt-equity swaps might have accelerated foreign direct inflows. This presumption, however, needs to be qualified by the fact that a debt-equity swap programme often accompanies other policy changes, both macroeconomic and foreign direct investment-related, that contribute to the creation of a more congenial investment climate. The independent contribution of debt-equity swap programmes, therefore, becomes hard to assess. Moreover, the preceding period contains years in which the immediate shock of the debt crisis had an usually depressing effect on foreign-direct-investment flows. These qualifications notwithstanding, it cannot

perhaps be discounted that debt-equity swap programmes do provide an important positive signal for foreign-direct-investment inflow.

2. Additionality of foreign direct investment

22. The qualifications noted above, coupled with the fact that investment through debt-equity swaps involves an implicit subsidy to the investor, give rise to the question as to whether swap-financed foreign direct investment is additional to what would have flowed without a swap programme. In view of the multiple determinants of investment flows (among which the subsidy through debt-equity swaps would be just one variable) and the relatively few years for which swap programmes have been in operation, it is difficult to reach any definitive conclusion regarding the additionality of foreign direct investment financed through debt-equity swap programmes.

23. There are several criteria which provide a qualitative basis for estimating the potential additionality of foreign direct investment through debt-equity swaps. One concerns the profile of investors. It is argued, for example, that a large part of investments undertaken by transnational banks is likely to be additional because banks traditionally prefer lending rather than equity investment. In a situation of excessive exposure in debt-ridden countries, the debt-equity swap incentive offers banks a way out through investments that they would not have probably made under normal circumstances. The sectoral composition of investment may also provide some clue to additionality. The argument here is that a significant part of investment in export-oriented industries through swaps may be additional because an up-front subsidy received through debt-equity swaps reduces the cost of investment, which is an important factor in determining competitiveness in the international market. In contrast, such a cost consideration may not be an important determinant for an investment decision regarding production oriented towards the domestic market because, in that case, it is easier to pass on costs to the consumers, especially in protected markets. However, this argument may not hold in mining and other natural resource-based exports, in labour-intensive manufactured exports or in others (for example, tourism) where the debtor country possesses a strong comparative advantage. The timing of an investment may also provide an indication of additionality. It takes a while before a planned investment is actually implemented. Therefore, investments made soon after the institution of debt-equity swap programmes are unlikely to be additional, because those investments were most likely planned before the institution of swap programmes. Based on similar logic, the expansion of an existing investment may also not be additional because, in these cases, companies usually already have project plans in progress; discounted funds from debt swaps are, at best, "icing on the cake". 12/ The stability and continuity of a debt-equity swap programme may also be important in determining additionality.

24. Based on such and similar considerations, an earlier study on the subject estimated that Chile registered the highest additionality, 64 per cent; the corresponding figures for Argentina, Brazil and Mexico were estimated at 45 per cent, 0 per cent and 44 per cent, respectively. 13/ Even in Brazil, transnational banks have made substantial direct equity investments. Moreover, the decline in foreign direct investment could be sharper but for the debt-equity swap

programme. In the Philippines, nearly 35 per cent of all debt-equity swaps (by both Filipinos and foreigners), amounting to $895 million as of 30 June 1990, was channeled to the export sector and 9 per cent was in bank and non-bank financial institutions, most of which involved direct conversion of transnational bank credit. Thus, there is a reasonable basis to assume that a part of foreign direct investment through debt-equity swaps has been additional.

25. In sum, it appears that in most countries, debt-equity swaps have induced some inflows of foreign direct investment that would not have occurred in the absence of these programmes. Debt-equity swap programmes have thus contributed to a desired objective, though its exact magnitude is difficult to quantify.

3. Direction of investments through debt-equity swaps

26. It has been noted before that, with the exception of Chile (until recently), debtor countries usually seek to direct foreign investment into desired industries or geographical areas. This section seeks to evaluate performance from that perspective.

27. An explicit priority in Brazil was to direct swap investment to underdeveloped areas. Quite apart from higher fiscal incentives to all investment in such areas, investors were allowed a greater share of discount benefits if investments were made in those areas through debt-equity swaps, compared to investment in other areas. This policy objective appears to have been largely met in Brazil, with close to half of the swap investments in the preferred areas.

28. Mexico's debt-equity conversion programme gave preference to privatization and export-oriented investment until recently when infrastructure projects were assigned a higher priority. Based on the experience through 1990, an earlier study of the Centre had concluded that the privatization objective did not seem to have had much success. 14/ However, nearly 30 per cent of authorized debt-equity swaps as of August 1990 was in the tourism sector and 10 per cent in in-bond assembly (maquiladoras). These figures suggest that a significant portion of investment has been channelled to export-oriented activities.

29. The Philippines has a detailed listing of specific priority sectors for investment through swaps. In the implementation of the programme, administrative approval rather than auctions was used to ensure that these priorities were met. Nearly 90 per cent of the investments materialized through debt-equity swaps as of June 1990 were in the preferred activities. The bulk went into production for export, accounting for 35 per cent of total investment.

C. Debt-equity swaps and other consequences

1. Appropriation of secondary market discounts

30. As noted in the introduction, debt-equity swaps operate through the existence of a difference between the face value of a debt paper and the value at which it is traded in the secondary market. As of August 1990, market prices of developing

countries' debt ranged from less than 15 per cent in the case of Argentina to about 70 per cent in the case of Chile. One question that arises, therefore, in the implementation of debt-equity swaps is the extent to which the debtor countries capture the benefits of these vast discounts on the secondary market. The experiences in this regard in different countries are summarized below.

31. Brazil did not undertake efforts to capture the discount until February 1988, when regulations were issued implementing a new formal debt-equity swap programme. One of its important goals was to capture a portion of the discount on Brazilian debt in the secondary market. The major innovation was the introduction of an auction mechanism through which discounts determined how monthly conversion quotas were allocated. This regulation also introduced the utilization of the official exchange rate, rather than the higher parallel one. The Government, however, limited monthly auctions to $150 million. Between February 1988 and January 1989, when the Government suspended the auctions following the launching of the anti-inflation Summer Plan, Brazil was indeed able to ensure an increasing share of discounts on its external debts, ranging on average from 27 per cent in March 1988 to 49 per cent in December of that year.

32. In Mexico, during the first phase of the debt-equity swap programme between 1986 and 1987, the major goal of the Government was to attract foreign direct investment. The benefit to the foreign investor was extremely high because the Mexican debt during that period traded at 50-55 per cent of face value, while the Government redeemed debt at full face value or close to it. In addition, the higher parallel rate of exchange was used rather than the official one. Just prior to the suspension of its programme in November 1987 (note that approval of applications submitted before the cut-off date continued until 1990), however, the Government established a 20 per cent tax on the difference between the purchase and the redemption price of its debt obligations. In the new swap programme introduced in 1990, the objective to maximize the share of the Government in the secondary market discount has been assigned a higher priority; administrative allocation was replaced by the auction mechanism. The results of the first auction suggest that the Government has been able to achieve its objective: $1 billion of debt conversion rights were distributed at 52.05 per cent discount, quite close to the secondary-market discount of about 57 per cent. In consequence of a second auction conducted in October 1990, swap rights for the amount of $2.5 billion were assigned at a discount of 51.9 per cent. The limit of $3.5 billion of swap agreed under the financing package of 1989-1992 was thus exhausted.

33. In Venezuela, in the auction held in November 1989, the discounts averaged 43 per cent, 15/ contrasted with the secondary market discount of around 60 per cent.

34. In other countries, although there have been attempts at maximizing the Government's share in the secondary market, this goal remains subordinated to the principal objective of promoting foreign direct investment or reducing the foreign debt, as the case may be. In the case of Chile, foreign investors were considered to be the major beneficiaries of discounts. 16/ In the Philippines, the fee imposed on debt-equity conversion was limited to 5 per cent of the value of the pesos received via debt conversion for priority investments till 1987 when the fees were revised to range from 6.7 to 24 per cent, depending on the priority of

investment and fresh money brought in. However, the investor could avoid the fees by funding at least 60 per cent of the investment with fresh money. Thus, depending on the fresh money, foreign debt could be exchanged for 76 per cent to 100 per cent of its face value in pesos at the official exchange rate when the secondary market price was around 50 per cent.

2. Debt-equity swaps and inflationary pressure

35. One of the strongest arguments advanced against debt-equity swap programmes is their adverse impact on domestic inflationary pressures. Essentially, the problem is that when local currency is exchanged for foreign loans, the domestic money supply is expanded and inflation increases. The validity of the argument, therefore, rests on (a) the impact of increase in money supply on inflation and (b) the quantitative importance of debt-equity swaps as a contributory factor to the increase in money supply in relation to other factors. In this context, it should be noted that not all forms of debt-equity swaps add to money supply. For example, if a swap involves the conversion of private debt into private sector equity, there will be no monetary impact. In this instance, there is a transfer of liquidity from the private debtor to the equity holder without any additional domestic credit creation or pressure on the domestic capital market. 17/ Similarly, in a debt-equity swap involving privatization of state enterprises, there is no disbursement of local currency to the private sector and hence no addition to money supply. Nevertheless, the potential inflationary impact of the conversion of public sector debt into private sector equity can not be overlooked. This concern appears to have played a significant role in the implementation of debt-equity swap programmes in different countries. The experiences in different countries in this regard deserve review.

36. The potential inflationary impact was an important rationale behind the suspension of the formal debt-equity conversion programme in Brazil in 1989. It is not that the programme was identified as a major cause of inflation, but it was not considered worthwhile to risk coping with one additional element of monetary expansion under hyperinflationary conditions where the execution of an effective monetary policy was extremely difficult. 18/ In order to control the inflationary impact of swaps during a period when the formal programme was in operation, Brazil established a ceiling on the volume of transactions at $150 million per auction. Furthermore, the Government regulated the disbursement of swap funds by distributing them to investors over a period of 90-180 days after an auction. In terms of an empirical assessment of the monetary impact, there are divergent views. According to one view, the impact was negligible. 19/ According to another, it was not inconsequential since swap-related disbursements from the treasury during 1988 represented a significant proportion of the treasury's deficit. 18/

37. In Chile, where inflation during the period of implementation of debt-equity swaps remained modest by its own historical as well as regional standards, the major mechanism for "sterilizing" the impact of monetary expansion has been the issuance by the Central Bank of long-term bonds in exchange for its foreign debt to both Chapters XVIII and XIX investors. The bonds pay only semi-annual interest, with the principal being amortized fully upon maturity. Chile's comparatively

well-developed domestic capital market enabled the absorption of the long-term public bond issues. Thus, this approach may not work in other countries. Another mechanism used in Chile to neutralize the monetary impact of debt-equity swaps - and also round-tripping - is the quota system of swaps. The Government controls the volume of debt-equity swaps emanating from Chapter XVIII through the auction system by setting a limit to the transactions. The volume of swaps set by the Central Bank, originally about $60 million per month, was later reduced to $25 million when the value of the peso fell sharply. It should be noted that Chile's success in neutralizing the inflationary pressures generated by its debt-equity swap programme through the bond mechanisms has had its costs. By competing with the private sector's long-term borrowing needs, the Government has crowded out private investment and created upward pressure on interest rates. Furthermore, interest payments on the bonds created for debt-equity swaps constitute a drain on the fiscal budget. 16/

38. In the case of Mexico, it has been said that although the main reason the authorities suspended the debt-equity swap programme in November 1987 was in order to implement a strengthened adjustment programme in late 1987, the observed unfavourable effects over the money supply, the public sector budgetary resources and the balance of payments also challenged the success of the programme. 20/ In the second phase of the programme, initiated in 1990, the Government will exercise more control over the inflationary impact of the swap programme since the winning bidder has up to 18 months for the disbursement of swap funds in domestic currency. As in other countries, the Government of Mexico also limits the volume of swaps in the auction system, as noted earlier.

39. In the Philippines, the rate of inflation during the period of implementation of the debt-equity swap programme was less than in the immediate preceding years. To contain the potential impact on money supply, the Central Bank explicitly incorporated debt conversion in its reserve money programme and set a monthly ceiling of $15 million on conversion using Central Bank debt paper during 1988.

40. This brief review of country experiences suggests that Governments are cognizant of the potential inflationary impact of debt-equity swaps and take measures to contain it. However, measures to neutralize the impact may entail other costs, as noted in the case of Chile. And where a ceiling is the chosen mechanism, there is an obvious trade-off between the volume of debt reduction and that of foreign direct investment.

3. Return of flight capital

41. In countries where both nationals and foreigners have been allowed to participate in debt-equity swap transactions, the scheme has indeed provided a powerful incentive for local residents to repatriate capital and thus revert capital flight. This has been particularly the case in Chile and the Philippines.

42. In Chile, swaps under Chapter XVIII (through which nationals are allowed to participate in debt-equity swap deals) provides the mechanism for the repatriation of capital. Nationals in fact accounted for 29 per cent of total debt-equity

conversions in Chile between 1985 and the middle of 1990. In the Philippines, the return of flight capital has been substantial. As of the first half of 1990, Filipino investors accounted for 45 per cent of the authorized debt-equity swaps and for 38 per cent of the materialized swap transactions.

43. As noted earlier, an important issue in debt-equity conversion concerns the problem of "round-tripping". No hard data are available to assess its incidence. However, in both of the above countries, measures were taken to reduce, if not eliminate, its scope.

44. In Chile, the Government has dealt with the problem of "round-tripping" by controlling the monthly volume of allowable debt-equity swaps by nationals and by monitoring the parallel exchange rate. In 1988, for example, when the gap between the official and parallel market exchange rates widened, the Central Bank responded by scaling back the quota and then suspending auctions briefly that year. Furthermore, local residents were allowed more investment flexibility and permitted to hold local securities acquired in exchange for swapped foreign debt in lieu of investing these in equities as incentives against round-tripping.

45. In the Philippines, in order to ensure that swap resources are actually utilized by Filipinos for the purpose of domestic investment and not for converting them back into foreign exchange at the parallel market, the Central Bank examines invoices, receipts, sale agreements, lease contracts and other relevant documentation to support the application for a swap deal. Furthermore, the Central Bank restricts the utilization of swap funds by requiring that those not immediately needed for a project be invested in non-transferable, peso-denominated Central Bank bills.

4. Impact on the balance of payments

46. There are several elements arising out of debt-equity swaps that enter into the balance-of-payments equation. On the positive side, savings on interest and amortization payments on the debt liquidated through swaps comprise one element. In so far as the return of flight capital is induced by swaps, the deficit in the balance of payments is eased. The use of swap-generated investment for the production of tradables contributes to an improvement in the balance of payments to the extent that net foreign exchange earning or savings are generated. There are several counteracting negative elements as well. Foreign investments flowing from debt-equity swaps give rise to future demand on foreign exchange for the repatriation of profits, dividends and capital. This, in turn, will partly depend on the rate of reinvestment. The demand for foreign exchange may be exacerbated by purchases on the parallel market for financing round-tripping activities. Moreover, there is an adverse effect on the inflow of foreign exchange in so far as foreign investment that would have flowed anyway is simply substituted by the swap investment.

47. This brief discussion indicates that there are too many unknowns in determining the impact of debt-equity swaps on the balance of payments. Note should be taken of the fact that regulatory instruments, such as new money

requirements, restrictions on remittances for a period of time and ceilings on the volume of debt-equity swaps, have been in part prompted by the concern for some of the adverse effects on the balance of payments.

48. One study on Brazil, based on a comparison of the interest savings on the debt liquidated through swaps with the likely profit and dividend remittances on account of swap-related investments, suggests that the balance-of-payments effect was substantially positive. However, the author cautions against attaching too much significance to this finding because these computations do not take the displacement effect of swaps on normal foreign-direct-investment flows into account and because informal conversions (a significant part of which involved pre-payment of non-matured debt with dollars bought on the parallel exchange market) widened the gap between the official quotation of the foreign exchange rate and the parallel rate, providing a greater stimulus for the under-invoicing of exports and the over-invoicing of imports. 18/

49. In the case of Chile, it has been noted that outward payments on account of Chapter XIX investments would become problematic only if a dramatic shift in other accounts created a foreign exchange crisis. The basis of the argument is that overall profit remittances through 1992 and 1993 are projected to be a fraction of debt-service and amortization payments. 16/ However, another study, taking into account interest savings, profit remittances and displacement effects of debt-equity swaps on normal investments, has concluded that the effect of Chapter XIX investments on the balance of payments was negative. 21/ But this finding can be faulted on the grounds of methodological problems in quantifying the displacement effect and of overlooking the impact of swap-related investment on foreign exchange earnings or savings.

50. In Mexico, a problem arose in early 1987, when residents were allowed to participate in swaps, in that those investors typically relied on the domestic foreign exchange market to buy dollars to finance the purchase of Mexican debt paper; thus, they created pressure on the foreign exchange market. Moreover, in some cases, foreign investors benefited from swaps to finance investment projects and then sold them to local residents and repatriated the sale proceeds through the acquisition of foreign exchange in the domestic market, leading to an undesirable outflow of capital. The subsequent swap authorizations included restrictions on the sale of investments financed by swaps. 20/

5. Privatization

51. One of the objectives of debt-equity conversion programmes in several countries has been to facilitate the privatization of public enterprises. In principle, these enterprises can benefit from privatization through the participation of both domestic and foreign entrepreneurs. These benefits can take the form of improved management and technology or the injection of fresh capital. Moreover, in so far as conversion reduces an enterprise's debt, its balance sheet improves, thereby enhancing its attractiveness for purchase by domestic entrepreneurs.

52. There are clearly two issues involved in privatization through debt-equity swaps: whether or not to privatize a state enterprise and, if so, whether debt-equity swaps are the appropriate means to achieve privatization. No a priori conclusion would be valid in all circumstances. Thus, for example, if an unsatisfactory performance of a state enterprise is due to price controls imposed by the Government, privatization per se will not help the enterprise unless the root cause is removed. In such cases, Governments need to take a conscious decision regarding the removal of price control, taking into account the consequences for the objectives that price control was intended to achieve. As to whether debt-equity conversion is the appropriate means to achieve privatization, it depends on what other options are available and on how a debt-equity programme is structured and implemented for the purpose of privatization. It should also be noted in this context that privatization through debt-equity swaps does not create new assets.

53. As mentioned before, 25 per cent of Chapter XIX investments in Chile until mid-1989 involved the sale of state enterprises and has invited the criticism that it resulted in the subsidization of foreign purchases of existing assets. The earlier debt-equity swap programme in Mexico did not achieve much success in respect of privatization. The proportion of 1990 auctions that has been devoted to privatization is not yet known. In the Philippines, some 27 per cent of implemented debt-equity conversions has been destined towards privatization, but its distribution between national and foreign investors is not known. There is a need for further research to assess the extent to which privatization programmes have been facilitated by debt-equity swaps and the consequential economic impact. At any rate, given the fact that debtor countries face severe budgetary constraints, the debt-equity swap merits consideration as one of the tools for privatization of ailing state enterprises.

IV. POLICY CONSIDERATIONS

54. This report has examined the effect of the debt-equity swaps on foreign direct investment and other development objectives of debtor countries, based on the experience of some key countries that have adopted such schemes. The inadequacy of the information available and the absence of stable and continuous programmes in most debtor countries do not permit firm conclusions regarding the role of swaps. Nevertheless, it is possible to indicate certain considerations that should receive the attention of policy makers.

55. Debtor countries pursue different objectives through the implementation of debt-equity swap programmes. The reduction of the debt stock is viewed as but one of these, and is often treated as an ancillary consequence of the use of swaps as a tool to promote domestic and foreign investment or to maximize the share of the discount in the secondary market. There are, however, some unavoidable trade-offs among the objectives that a country seeks to achieve.

56. For example, strict regulations governing the use of swap resources, restrictions of swap investments in certain industries, the requirement of fresh money and strict limitations on profit remittances and capital repatriations seem

to be a disincentive to foreign investors. On the other hand, there is, no doubt, a bona fide basis for concern about channeling swap resources into high priority sectors or areas, particularly in export-oriented projects, given their likely positive association with additionality and a favourable impact on the balance of payments.

57. Although in some countries administrative decisions to allocate swap resources seem to be very effective in directing the flow of investments into desired economic activities, they may conflict with capturing a larger share of the secondary market discount through the auction system. The same trade-off applies to keeping the swap subsidy substantially high to promote additionality of foreign direct investment.

58. The participation of national investors in debt-equity swap programmes can be legitimately justified on the grounds of avoiding the inequity in limiting swap incentives to foreigners only. It also reduces the future foreign exchange costs of swaps since local investors do not usually enjoy access to foreign exchange for the repatriation of profits. The available evidence, however, suggests that local residents engage in round-tripping, which places pressures on exchange markets.

59. It appears that the existence of a well-developed domestic capital market is an important requirement for a successful reduction of the inflationary impact of swaps. But the issuance of long-term public bonds to finance the local currency needs of swap operations can also reduce the availability of funds to the private sector, crowding out domestic private investment and putting upward pressure on domestic interest rates. This in turn, increases the debt-servicing obligations of domestic debt created to finance the swap operations without inflationary consequences. In some countries, ceilings have been placed on the amount of swap transactions in each auction in order to mitigate the inflationary effects of debt-equity swaps; in others swap transactions have been suspended altogether following an anti-inflationary programme. These measures obviously limit the scope of the beneficial impact that swaps can have.

60. The privatization of state enterprises and the redefinition of the role of the private sector seem to be linked to debt-equity swap programmes in many countries. In principle, the concerned enterprises can benefit from better management and technology transfer as a consequence of privatization. However, depending on the regulations governing the eligibility of investors and price-setting, the use of the swap mechanism can create other difficulties. Countries can run the risk of surrendering the ownership and control of key industries to foreigners and allow buy-outs of national assets at subsidized prices without obtaining an injection of fresh capital which many ailing public enterprises badly need. Further empirical research on the role of debt-equity swaps in privatization programmes could provide useful insights.

61. The above provides a few illustrations of the many trade-offs inherent in swaps. Policy-makers considering the implementation of debt-equity swap programmes must decide what priorities to emphasize and weigh very carefully their costs and benefits and structure their programmes accordingly.

62. Stability and continuity are major factors in determining the success of a debt-equity swap programme. These considerations further heighten the need for a careful structuring before a programme is put in place so that drastic changes are not required in the course of implementation. However, this does not obviate the need for surveillance over adverse consequences and for taking appropriate corrective actions.

63. It should also be noted that none of the countries which have implemented debt-equity swap programmes has so far succeeded in attracting voluntary loans from commercial banks, not even Chile, despite its outstanding performance in terms of an effective use of debt-equity swaps as an instrument of debt reduction. One effect of Chile's success has been to increase significantly the secondary market price of the country's debt leading to a slow-down in conversion through the erosion of incentive arising out of the differential between the secondary market price and the face value of debt without a commensurate increase in the country's access to voluntary credit. This demonstrates the limitation of debt-equity swaps per se in generating enough confidence in an economy to assure its return to the international capital market.

64. Finally, the success and the continuity of a debt-equity swap programme is strongly conditioned by a country's macroeconomic performance in such areas as control of inflation, exchange rate and balance-of-payments management and the development of local financial and capital markets. The suspension of the programmes in Brazil and Mexico was prompted by persistent macroeconomic imbalances for which debt-equity swaps could be, at best, an inadequate remedy. These imbalances also created a situation in which the adverse consequences of debt-equity swaps were aggravated. Viewed in this light, debt-equity swaps, with all their attendant benefits and costs, represent one more tool for a debt-ridden country's economic management. It is a complement to, and not a substitute for, the other far more important macroeconomic instruments, such as monetary, fiscal and exchange rate policies; nor can it be a substitute for other mechanisms of debt reduction which debtor countries urgently need.

Notes

1/ See Official Records of the Economic and Social Council, Supplement No. 6 (E/1990/26), chap. I. A.

2/ See the report of the Secretary-General on transnational banks and external indebtedness (E/C.10/1990/11), pp. 15-17.

3/ See Debt-Equity Conversions: A Guide for Decision-makers (United Nations publication, forthcoming), chap. II.

4/ For a more detailed description of the benefits and costs, see Debt-Equity Conversions ..., chap. III, sections A and B.

5/ Armando L. Suratos, "Case study of the Philippine debt to equity conversion programme" (New York, United Nations Centre on Transnational Corporations, 1990), mimeo.

Notes (continued)

6/ Business International, The Debt Equity Swap Handbook (New York, Business International, 1989), p. 9.

7/ See Steven M. Rubin, ed., Debt Equity Swaps in the 1990s: Swaps Under the Brady Umbrella (London, The Economist Publication, 1989), pp. 110-111.

8/ Joel Bergsman and Wayne Edisis, "Debt equity swap and FDI in Latin America", in Debt Equity Swaps in the 1990s: Swaps Under the Brady Umbrella (London, The Economist Publication, 1989), p. 65.

9/ Business International, "Debt equity swap update" (August 1990) and Business Latin America (21 August 1989).

10/ Report of the Secretary-General on transnational banks and external indebtedness, (E/C.10/1990/11), p. 16.

11/ See The World Bank, Financial Flows to Developing Countries: Current Developments (Washington, D.C., 1990), table 4, p. 10, and statistical appendix, table 5.

12/ Business International, The Debt Equity Swap Handbook, op. cit., p. 2.

13/ Berman and Edisis, op. cit.

14/ Debt-Equity Conversions: A Guide ..., op. cit., chap. V.

15/ Business International, "Debt equity swap update" (November 1989).

16/ Mary L. Williamson, "Chile's debt conversion programme" (New York, UNCTC, 1990), mimeo.

17/ See Michael Blackwell and Simon Nocera, "The impact of debt to equity conversion", Finance and Development, 25 (June 1988).

18/ Ricardo Bilschowsky, "The Brazilian experience in debt equity swap; an evaluation" (New York, United Nations Centre on Transnational Corporations, 1990), mimeo.

19/ Banco Central do Brasil, Conversao da Divida em Capital de Risco, Retrospectiva and Avalicao (Brasilia, Banco Central, December 1989).

20/ Government of Mexico, Ministry of Finance, Undersecretariat for International Affairs of Ministry of Finance, "Debt-equity swap programmes; the Mexican experience" (New York, United Nations Centre on Transnational Corporations, 1990) mimeo.

21/ Ricardo A. Lagos, "Debt relief through debt conversion: a critical analysis of the Chilean debt conversion programme" (August 1989), mimeo.